

A LITERATURE ANALYSIS OF THE PROVISION OF MANAGEMENT AND
ADVISORY SERVICES REGARDING AUDITOR INDEPENDENCE

A Thesis

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By

Damon Andrew Ambrosini

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Distinction Examination Committee:

Dr. Richard Young, Advisor

Dr. Eric Spires

Dr. Daniel Jensen

Introduction

The question of whether an auditor can remain independent when they provide Management and Advisory Services (MAS) to its clients has been investigated in professional, governmental, and academic literature. The purpose of this study is to explore the conclusions that are drawn from each of these communities and provide a cross analysis of the stances that each body presents. In section two, I present the various forms of the definition of auditor independence. In section three, I introduce the history of the auditor independence question including the pivotal Metcalf Committee investigation (1976). In the fourth section, I characterize the stance of the United States government on this issue. In the fifth section, I similarly characterize the accounting profession's stance. In the sixth section, I describe current relevant academic research in order to test whether or not it is addressing the issues important to the profession. The seventh section provides my conclusion to this study and my recommendations for the future of academic research in this area.

Definitions of Auditor Independence

The realization of a single definition of auditor independence has so far evaded the academic, professional, and governmental communities. Presently the Independence Standards Board (ISB) is researching various definitions from the different communities in an effort to compile a working definition for this purpose. My intention for introducing a definition of auditor independence is to provide an exposure to this controversial topic and to illustrate the qualities that are being considered in reference to auditor independence.

Academics have attempted to define auditor independence using sophisticated models and intuition. DeAngelo (1981) reasoned auditor independence should be described as the ex ante value of the audit to consumers. She estimated this value as the “perceived ability to (1) discover errors or breaches in the accounting system, and (2) withstand client pressures to disclose selectively in the event a breach is discovered” (p. 113). DeAngelo concluded based on her model of audit ‘low balling’ that “the level of auditor independence is defined as the conditional probability that, given a breach has been discovered, the auditor will report the breach”.

Antle (1984) addressed the profession’s failure to arrive at a single definition of auditor independence. Antle claimed that although both the American Institute of Certified Public Accountants (AICPA) and the Securities and Exchange Commission (SEC) have regulations requiring auditor independence, the lack of a single definition has been a source of controversy. Antle further remarked that the entire debate of auditing firms continuing to provide MAS rests on whether these services impair the quality of audits. Finally Antle’s inquiry used a game-theoretic principal-agent model that describes auditor independence and the strength of the relationships between the auditor and the owner. Antle created his model around verification, which he considers the essence of auditing. He defines independence in terms of “an auditor’s resistance to managerial pressure or interference”.

Other academics have attempted to define auditor independence. Magee and Tseng (1990) define independence as “an auditor’s making reporting decisions consistent with his or her beliefs as to whether the reporting decision may be regarded as an audit failure” (p. 317). Magee and Tseng further expand by claiming “an auditor compromises

his or her independence when he or she allows the client to use a reporting policy that he or she believes would be viewed as an audit failure” (p. 317).

Finally the ISB cites Penno and Watts definition from “An Independent Auditor’s Ex Post Criteria for the Disclosure of Information” (Supplement 1991). They describe auditor independence as follows. “[I]f the auditor’s preferences over disclosures depend neither directly on management’s wishes nor indirectly on management’s preferences (for example, through future audit fees), one could say that the auditor is ‘independent’ (ISB Append. C)” These definitions represent a few of the many attempts by academics to define auditor independence, but are limited based on the issues looked at.

The ISB provides a careful examination of the various definitions of auditor independence in its “A Conceptual Framework for Auditor Independence” (2000, Append. C). The ISB stresses the definition that results from its work should result from the most thorough viewing of the goals of auditor independence. The ISB arranges the numerous examples of goals it provides into one of two categories. These two categories are broken into goals related to financial statement reliability (or independence in fact) and goals related to the perceptions, credibility, and confidence (also known as independence in appearance). Relying on these two sources of goals, the ISB then categorizes the definitions it is considering into one of five groups. These groups comprise of definitions based on (1) a personal attributes approach; (2) an activities and relationships approach; (3) a focus on perceptions, credibility, and confidence; (4) a multidimensional approach; and (5) the academic approach.

At the time of this study, much deliberation by the ISB has gone into defining the term auditor independence. While a definitive conclusion has not been reached, the ISB

has narrowed its search to twelve definitions before the finalization of the conceptual guideline. The ISB concludes their discussion of definitions of auditor independence by offering a final comprehensive definition including all of the components considered important. This definition states “Independence is freedom from pressures and other factors- indicated by certain activities or relationships- that may impair, or may be perceived to impair, the willingness of auditors, both individually and as a group, to exercise appropriate personal attributes (including objectivity and integrity) when performing an audit” (p. 95). The ISB’s comprehensive definition offers the most extensive consideration given to the issue of defining auditor independence.

A History of Auditor Independence

The issue of auditor independence for firms that offer non-audit services has historically been an area of concern. The United States Congress, the SEC, the Public Oversight Board (POB), the AICPA, and academics have each taken turns studying the issue (Panel, 2000). In 1932, some of the earliest forms of concern over the auditor independence issue began to surface. The AICPA questioned whether they should provide regulations stating that an auditor could not be an officer or director of clients and then concluded that these regulations would be unnecessary. This did however initially raise the point of independence in appearance for the profession to see. The Securities Acts of 1933 first described what the SEC would consider to be a lack of auditor independence. They considered it a breach of independence if the auditor served as an officer or director, or had any direct or indirect interests in public clients. The goal of the SEC’s definition was to achieve independence in appearance as well as

independence in fact. In 1941, the AICPA adopted and expanded this rule to include all clients of auditors instead of solely publicly traded clients.

In 1947 the AICPA issued a statement that recognized the expansion in the scope of services auditors were beginning to provide. While this statement did not specifically address the issue of auditor independence, it presented the first time anyone looked at the expanding horizons that were evolving in the profession. The statement specifically looked at tax advice, accounting assistance, advice to businesses in the installation of accounting and cost systems, budgeting, and internal control. The AICPA statement suggested that these practices had evolved from requests of audit clients for additional services that were natural for auditors to be knowledgeable about. A second point of note presented in this statement was the argument that providing these services increased the auditor's knowledge of the firm it was auditing and allowed them to conduct better audits, thereby increasing the value of the auditor's opinion. The Panel on Audit Effectiveness extrapolated this statement by stating that the evolution of specialty skills into consulting practices, including MAS services, was a logical extension of the auditing practice.

The Wheat Committee (1971), the Trueblood Committee (1971), and the Cohen Commission (1974) represented the profession's attempt to take an introspective look at its own practices. These committees looked at the standard setting policies adopted by the profession and identified issues associated with these procedures. Until 1975, accounting practices were generally left up to the accounting profession, which consisted of a hierarchy of organizations including the AICPA (Table 1). At the end of 1975, and throughout 1976, a subcommittee of the United States Senate lead by Senator Lee

Metcalf undertook a rigorous study of the accounting profession and the Federal government's role in establishing accounting practices. In a letter to the Chairman of the Senate Government Operations Committee, Abraham Ribicoff, Senator Metcalf claimed that a series of corporate failures and financial difficulties had brought the attention of the Senate upon these issues. Senator Metcalf also stated the major purpose of the subcommittee's inquiry was to provide Congress and the investing public with information regarding the role of private organizations and the Federal government in setting and administering accounting practices. Senator Metcalf asserted that a comprehensive look at such an important issue had been long overdue and that interest in the subcommittee's work by the accounting profession, the academic community, and Federal agencies indicated that the value of this study was enormous and would be instrumental in the regulation of accounting.

The Metcalf Committee began its report by first looking at the firms, specifically the largest in the United States, then known as the "Big Eight". This exploration of the firms concluded that there was little evidence supporting that the firms were able to serve the public effectively or were even independent in fact. The subcommittee specifically alleged that MAS went beyond the rational scope associated with accounting practices and that the firms were breaching auditor independence. The subcommittee went on to describe some of the important qualities of the independent auditor stating that the independent auditor was required to agree with the accounting methods their clients utilized and to certify the accuracy of the client's records. The subcommittee maintained that requiring the position of the auditor as independent in appearance and independent in fact was the cornerstone of the profession and the only goal worth achieving. The

subcommittee advocated that strict adherence to independence in appearance and independence in fact was the only way to restore confidence in the profession. The subcommittee alleged that the “Big Eight” had seriously impaired their independence with their involvement in MAS.

The Metcalf Committee concluded its discussion of the private organizations used for establishing accounting policies by alleging that the “Big Eight” were able to influence the AICPA, the organization with the most control in setting standards for accounting policies. The subcommittee justified this rationale by claiming that the AICPA was organized in a way that permissively allowed the “Big Eight” to influence and control its power structure. With control of the AICPA, the “Big Eight” firms were able to justify any policy that would lead to the selfish goal of increasing revenues through MAS services. The subcommittee aggressively maintained the “Big Eight” controlled a circular pattern that began with the “Big Eight” controlling the AICPA and ended with the “Big Eight” being able to select accounting methods that benefited their clients. This pattern suggests that the “Big Eight” were able to control the decision of which practices were allowed. The subcommittee argued that this freedom provides a motive for a breach in auditor independence, if not independence in fact then certainly in appearance. In an attempt to restore public confidence in actual independence the committee provided a list of sixteen recommendations. At the core of these recommendations was the idea that the Federal government become more involved in establishing accounting procedure goals and objectives as well as standards, thereby reducing the power of the “Big Eight” firms.

The release of the extensive Metcalf Committee report provided a source of discussion throughout the next two decades. The first to respond to the allegations were the “Big Eight” firms, many who were outraged by what they felt was slander of their work. Most of the firms released publications disputing the findings of the committee’s report. Arthur Young’s “Professional Responsibilities in a Time of Change” was a sixty-five page example of such a publication. This compilation included an in depth view of what Arthur Young saw as the problem and the challenge, as well as direct responses to each of the Metcalf Committee’s suggestions. While the report granted that the committee was correct on some aspects, it criticized and dismissed much of what the Metcalf suggested.

Throughout the 1980’s, academics attempted to address the issue of auditor independence, drawing much of their motivation from the Metcalf Committee. Linda DeAngelo started the decade with her classic work “Auditor Independence, ‘Low Balling’, and Disclosure Regulation: A Summary” (1981). While DeAngelo’s paper did not specifically address the issue of MAS’s effect on auditor independence, she did examine ‘low balling’, a phenomenon many consider to be a precursor to the auditor independence problem. ‘Low balling’ occurs when initial audit fees are set below the initial cost incurred to provide the audit. This paper seemed to springboard research into the MAS/ auditor independence issue and was one of the most cited works in MAS research.

Other academics explored auditor independence in search of examples that would lead to a definite breach of auditor independence. Simunic (1984) compared clients’ audit fees for those who employed MAS from the auditor with those that did not.

Palmrose (1986) conducted a similar study in order to reinforce Simunic's findings. Beck, Frecka, and Solomon (1988) took a specific look using an empirical study at auditor independence and MAS and concluded that auditor independence is never substantially impaired by MAS services.

The continued debate over the findings of the Metcalf Committee was not limited to academics by any means. Lee Berton, a journalist, followed the auditor independence debate for firms who provide consulting in his articles for the Wall Street Journal. In his article "Consulting for Audit Clients: A Conflict of Interest?" (1987), he addressed the issue of the growing dollar amount of fees being collected by the "Big Eight" firms for MAS services and also voiced some of the complaints made by others in the consulting practice. Later Berton covered inquiry of the SEC on the auditor independence issue in his article "SEC Is Studying Independence of Firms Doing Consulting and Accounting Work" (1989). Berton's work represented a renewed interest by the public in, what seemed to be, an ongoing battle between the "Big Eight" accounting firms and the government.

While the professional firms were quite busy defending the endless stream of allegations from critics, they funded various areas of research in support of their stance. Pany and Reckers (1988), funded by Peat Marwick, maintained that the provision of MAS had little or no impact on audit decisions and claimed that the auditor still remained independent in fact. The study also defended the history of the auditor independence debate, mentioning that all studies until 1988 had concluded that there may be a problem of independence in appearance, but there never seemed to be a problem of independence in fact.

In the late 1990s and early into the 2000s, the SEC began to take a renewed interest in the auditor independence issue. The escalation of fees collected for MAS and the expansion of services offered spawned an in depth investigation and an increasing importance placed on independence. Discussions between the AICPA and the SEC lead to the formation of the ISB, as well as the Public Oversight Board creating the Panel on Audit Effectiveness. The SEC then asked the ISB to formulate a conceptual guideline for auditor independence, including a discussion on MAS, which at the time of this study was still under review. This tentative guideline, along with the Panel's findings, served as a beginning point for an all out SEC investigation on the issue of auditing firms providing consulting. The Panel stood divided on the issue of auditing firms providing non-audit services. In their report, they brought together a list of conclusions from both sides in order to fully represent the breadth of the issue.

Recently the SEC has undergone an investigation in order to consider the adoption of three regulations regarding auditor independence. The first two are related to investments made by auditors and employment relationships regarding clients. The third specifically looked at the scope of services offered by auditing firms. The regulations are based on proposed principles that would provide enduring guidelines on auditor independence. These four principles require that the auditing firm not: "(1) [have] a mutual or conflicting interest with the audit client, (2) audits his or her own firm's work, (3) functions as management or an employee of the audit client, or (4) acts as an advocate for the audit client" (Proposed Revision Summary). These regulations provide a general standard that is based on the commonly accepted idea that auditors must be independent in appearance as well as fact. The SEC is also reviewed nine non-audit services for

clients that are inconsistent with auditor independence, seven of which are already outlawed by the AICPA or the SEC. These activities are bookkeeping or other services related to the client's accounting records, financial information systems design and implementation, appraisal or valuation services or fairness opinions, actuarial services, internal audit services, management functions, human resources, broker-dealer services, and legal services.

The SEC has commissioned the testimonies of expert witnesses from every facet of the accounting profession in order to provide a revealing and all-inclusive view of the problem and the popular opinion. Many of the head partners of the "Big Five" firms were called upon to provide testimony to the commission, as well as the head of the SEC, and international accounting experts. Many have provided stories or arguments over various facets of the profession in order to sway the commission. Currently the SEC has adopted the policies considered, but more can be expected in the future of the auditor independence debate.

The United States Government's Perspective on Auditor Independence

After the completion of the Metcalf Committee's report, the government seemed to waiver over their stance on the auditor independence issue. Senator Metcalf clearly indicated he found that the practice of MAS provided a breach of auditor independence and that many changes would be required in order to repair the state of the accounting profession. In particular, Metcalf had two major concerns. The first of these was based on the hierarchy of the accounting establishment. Metcalf and the members of his committee felt the private sector of the accounting profession had entirely too much

control regarding policies and disclosure. The second concern the Metcalf committee presented was the lack of independence by the profession as well as a seemingly lack of dedication by the biggest public accounting firms to adjust their policies to reinforce their position against the perceived lack of independence.

These concerns lead to a series of sixteen recommendations by the Metcalf Committee to the U.S. Government. They recommended that Congress exercise stronger control over the accounting profession by establishing comprehensive accounting objectives for the Federal Government to guide agencies. The recommendations also specifically stated that the Federal Government needed to “restore public confidence in the actual independence of auditors... by promulgating and enforcing strict standards of conduct for such auditors” (Metcalf, p. 22). Metcalf called for restricting any activities that may be viewed as a breach of independence in fact or appearance and also explicitly attacked direct or indirect representation of clients’ interests as well as any non-accounting MAS and further recommended that the SEC take charge of this mission.

After the allegations of the Metcalf Committee, the Federal Government began to take an increased interest in the auditor independence issue. Throughout the 1980s the public followed the concern over the auditor independence issue as consulting fees began to take on an increasingly larger percentage of accounting firms revenues. Wall Street Journal reporter Lee Berton quoted Michael Barrett, chief counsel for a House subcommittee, as stating that there exists a “serious question as to whether accounting firms should do any consulting work for audit clients” (Berton 1987). Barrett also went on to state that a breach of independence in appearance caused the profession to suffer as

much damage as a breach of independence in fact and created a black eye on the profession.

In 1989 the SEC launched a six-month investigation on whether or not consulting services impaired auditor independence. This investigation was spawned in an effort to “ease some of the conflict-of-interest rules for auditors in joint ventures with clients” (Berton 1989). John Riley, associate chief accountant of the SEC, stated, “To us, doing a fairness opinion on mergers and some corporate restructuring obviously impaired an outside auditor’s independence” (Berton 1989). While Riley’s comment was pointed at a specific example of Arthur Andersen providing the valuation of assets, the study spanned all non-accounting services. Riley further commented that the U.S. government was not concerned with the firms providing these services, but stressed the services should only be provided for non-audit clients.

One of the primary reasons for the U.S. Government’s continual interest in the auditor independence issue is the avid push by other professionals who are protecting their own interest by claiming that an impairment of independence exists. Berton argued the most common source of complaint over auditor independence seemed to come from other non-accounting professional firms. While many professionals in these firms seemed to be voicing valid complaints, a common concern for lost business erupted from the slew of opinions that were voiced. Ettore Barbatalli, chairman of the Valuation Research Corp., commented that five years prior, his firm had lost little or no clients to any of the large CPA firms. He claimed to be losing “up to four clients a month” further commenting that he felt that “it’s a conflict of interest for the auditor to tell his clients that his CPA firm is the most qualified for a consulting job” (Berton 1987). A survey of

one thousand businessmen, financial analysts, bankers, attorneys and academics noted that there existed a growing trend towards professional belief that CPA firms were impairing their independence by offering non-accounting services. In Berton's coverage of the auditor independence debate, he reported that non-accounting services provided by the largest CPA firms were starting to infringe on investment bankers territory for merger and acquisition clients. This was a major factor for yet another Congressional subcommittee hearing, in what were becoming regular events for Congressional inquiry.

Near the end of 2000, the SEC provided and passed a proposal that attempted to modernize the auditor independence requirements in three primary areas. The SEC hoped to be able to provide the profession with definitive regulations regarding non-audit services and to ultimately end the auditor independence issue. Consistent with the recurring argument, the regulations prescribed would only apply to incumbent auditors and MAS providers. In order to provide this a solution to this problem, the SEC decided to undergo a comprehensive investigation that included testimony and input from governmental, academic, and professional experts.

One component utilized by the SEC was the Panel on Audit Effectiveness. The Panel prepared a report based on a review and evaluation of audits conducted on publicly traded financial statements. The Panel included an auditor independence component and discussion in order to assist the SEC. While the Panel provided excellent feedback on the auditor independence issue, the Panel remained split when it came to its stance on whether there was conflict and how the SEC should approach it. Instead the Panel summarized arguments for both sides to be used suggestively in helping to persuade the SEC's decision.

The Panel, however, did agree on a number of issues. These issues were “(1) Independence is essential for promoting public confidence in the audit process, and must be monitored continuously, (2) so long as auditors provide non-audit services to audit clients, there will be at least an issue with respect to the appearance of independence, (3) there has been an explosive growth in non-audit services in recent years, to the point where many large firms’ revenues from these services exceed their audit revenues, (4) in their zeal to emphasize the array of services that CPAs offer, audit firms and the AICPA scarcely acknowledge auditing services in the public images that they portray. This serves to exacerbate the independence issue and to downplay the importance of auditing” (POB 115).

The proponents for issuing a ban excluding the practice of non-audit services provided a set of guidelines in order to determine which non-audit services would not be acceptable for an audit firm to practice. MAS were argued to be conflicting to the role of the CPA. They further argued the basis for this debate and the source of the conflict rested on whom the CPA was representing. Audit services rely on the representation of the general investing public, while all MAS seem to advocate the clients’ interest. The proponents of the exclusionary ban warned that use of a case-by-case scenario of non-audit services in order to determine which MAS were acceptable would be disadvantageous because of the amount of time spent on narrowly defining what practices are authorized. The proponents felt an exclusionary ban would be most effective because it rewarded firms that were already sensitive to the auditor independence issue and placed them on the same competition field as other auditors. The exclusionary ban would also be a low cost alternative for the government to regulate. Finally, the proponents

commented that disclosure of non-audit services would not be effective today or in the future. The proponents claim the investor will not be able to synthesize the information correctly and that since auditing services are profitable today as well as in the future, there is no reasonable argument to not having independence in fact and appearance.

The opponents of a ban that excludes the practice of non-audit services argued that such a rule would not be beneficial and would therefore hurt the auditing practice. They believe the audit practice has survived this long without such a rule, that there is no need for one now, and further remain confident that audit committees, management, and auditors are able to make acceptable decisions regarding their own independence. The main arguments presented for their case concern the issue of the client having to decide whether they would like one firm to be an auditor and another as an MAS provider. The opponents also feel the different representation of management and the investing public are not usually at odds with one another. The opponents claim the auditor independence responsibility is a normal business responsibility and a handy rule to simplify this is not necessary. Auditors are increasingly utilizing specialists in their line of work and are able to rely on the experts within their own firm. This also allows for intellectual growth in that auditors are now able to broaden their own knowledge. The panel concluded by recommending to the SEC and ISB to continually evaluate any method of disclosure requirements the SEC found suitable.

Included in the SEC testimony was a speech from Arthur Levitt, Chairman of the SEC. The Chairman seemed to voice the opinion of the U.S. Government within his short but elaborate speech. Levitt proclaimed the role of the CPA as a public defender and a distinguished profession that should not weaken their reputation in order to make

extra profits in an already lucrative profession. Levitt further asked the commission to remember the ethics and responsibility given to the auditor and to enact the ban on non-audit services. His speech seemed to promote the stance taken by the U.S. Government since the Metcalf Committee. The U.S. Government has always taken a more conservative stance on the auditor independence issue than has the profession.

Wall Street Journal reporters Weil and Tannenbaum (2001), wrote an article that was released in the midst of the attempts by the U.S. Government to provide a finalized solution to the auditor independence issue, once again returned to the professional concern of increasing non-audit service fees collected by large accounting firms. The authors questioned the SEC policy of public disclosure by companies who utilize these services when the auditor also provides audit services. Weil and Tannenbaum also reported immense pressure from industry wide support forced the SEC to back off its original position, which was to ban MAS from being provided by the auditor. This provides further evidence of the ongoing inability of the U.S. Government to provide a stance that is agreeable to all sides of the auditor independence issue.

The Profession's Perspective on Auditor Independence

During the compilation of the Metcalf Committee's report the profession attempted to find answers to its own questions about the auditor independence issue. The Cohen Commission (1974) examined the provision of non-audit services in conjunction with the role of the auditor. The commission points out that total independence can never occur in a practical world and that attention should be placed on the amount of independence needed to make the financial statements useful to society. The commission

further states that no evidence of a breach of independence has ever been brought to light, but that a significant belief that an impairment exists would affect the entire industry by questioning the value of audits. After conducting a comprehensive survey and discussion with many professionals, the Cohen Commission determined that a change in the regulatory policies regarding MAS was not needed, and that interference would cause more damage than good.

After the release of the Metcalf Committee's report, the profession responded with scathing publications in order to voice their stance. The firms felt that Metcalf had unfairly characterized their position as well as misinterpreted many of the positions they saw as problems. In particular Arthur Young published a direct response titled "Professional Responsibilities in a Time of Changes" that defended the firms on several pointed issues. Arthur Young stated that although they believed they had never entered into collusion or conspiracy with any parties, "the Staff study sometimes suggests, and sometimes specifically charges, that we have done all these things" (Arthur Young, 1). Arthur Young specifically implied there was a fault of over reliance on Abraham Briloff in the Metcalf Committee's study, whom they believed actually embodied the minority opinion on a great many issues. Arthur Young also took great offense at the implication all auditors that worked in the largest firms are not independent. The firm stated "the profession is grounded in carefully considered concepts of independence, public service, and public interest and is guided by a substantial and comprehensive ethics code which causes members of the profession to avoid even the appearance of conflicts of interest and to maintain their objectivity" (Arthur Young, 1).

Another issue Arthur Young addressed specifically was the provision of MAS. The firm dissented with the Staff study suggestion that these services are inherently a violation of independence. They claimed the provision MAS to audit clients is a natural component of the auditing function, citing examples of helping a client create a more effective and efficient set of internal controls, record-keeping procedures, or methods of accounting for various transactions. The firm further claims that these improvements benefit society by creating better accounting systems for management and for the use of accountability in organizations which not only is more economical, but also more beneficial to the shareholder. The firm also stated that prohibiting auditors from providing these services denies society from benefiting from this specialized expertise that should be capitalized upon. Finally the firm criticized the Staff study for failing to provide evidence that the provision of MAS did indeed contribute to the failure of audit performance.

Berton reported on the profession's stance as it avidly defended its position on the auditor independence problem. The profession stated that independence is a foundation and cornerstone of the entire profession and that no firm would risk this professional responsibility for the sake of profit. The profession placed independence in fact over independence in opinion and, as Berton (1987) described, have effectively constructed a Chinese wall between auditing and consulting. Then managing partner of Arthur Andersen, Duane Kullberg, claimed that the auditor independence issue existed only as a red herring and that the public should focus more on how to make auditors more useful to the public. Kullberg further conceded that the auditor independence issue presented a "conflict-of-interest appearance problem" but the critics using this argument

“complain about unfair competition [and] are really complaining about competition” (Berton 1987). Robert Mednick, managing partner for Arthur Andersen, also fought passionately on behalf of the profession. Mednick claimed on behalf of the firm that “we believe the SEC is unfair imposing a U.S. standard to the rest of the world” when it came to the MAS question (Berton 1989).

During the SEC’s intensive investigation to determine a final solution to the auditor independence issue, a number of members of the profession were called on to voice their opinion to the SEC. The proposal made by the SEC was harshly criticized by the AICPA as well as many others in the profession. Much of the profession felt that the rules were put together in haste and were flawed. The firms claimed that the restructuring due to an exclusionary ban of MAS offerings would result in the loss of competencies in non-audit professionals and that firms would have great difficulty recruiting top accounting students without the ability to increase the intellectual quality of the work. Two of the “Big 5” firms, Ernst & Young and PricewaterhouseCoopers claimed to be generally supportive of the SEC’s rulemaking initiative with both firms going so far as to sell off their consulting services. The rest of the “Big 5” claimed more revision had to be made to create effective rules.

Steven Butler, chairman of KPMG, claimed in his testimony that investor protection was the key to his organization, but that the SEC’s proposed restrictions would “irreparably damage auditors’ ability to protect investors” (Butler 2001). Butler further claimed that two effects would become evident upon adoption of the proposal: the profession would no longer be able to attract the best and brightest students and the new rules would reduce the profession’s ability to meet clients’ needs and also provide

effective audits. Butler warned that the dawning of the information age had forever altered the profession and forced the firms to keep up with the demand of the clients. Butler argued that the profession relied on the changing practice of the profession to recruit and keep employees intellectually engaged. The information age also made it difficult to compete with technology and start up firms for new employees coming out of college. Butler concluded with a remark that “non-audit service restrictions would hurt our clients by increasing audit costs while threatening audit quality and limiting client choice” (Butler 2001).

James Schiro, CEO of PricewaterhouseCoopers (PWC), expressed PWC’s concern by stating that the SEC had a stronger duty to complete with these proposed regulations. Schiro urged that rather than attempt to define and ban any unacceptable non-audit service, the regulating body should attempt to create rules that would protect the future as well as the present. Schiro claimed that no one could know what MAS would be demanded ten years from now and that rules needed to be created that would grow with the times. Schiro declared the main objective of the public accountant is to protect the public interest, but that auditors could only do this by recognizing new challenges within the auditing process. Schiro dismisses the popular opinion that quality audits cannot be conducted if MAS are prohibited and further recognizes that while rules created for the United States market may not fit neatly into other cultures, the SEC should give special consideration to rules that provide a global impact. Schiro also claims that excluding MAS from public accounting firms would not harm the job market because recreating the auditing model to fit these new regulations would still provide interesting and challenging work.

The statement of Thomas Goodkind, a CPA that has worked in the auditing profession for nearly six busy seasons, presented the opinion of the smaller firm auditor. Goodkind took a stance very similar to that of Arthur Levitt, playing up the role of the auditor as a public defender. Goodkind advocated the adoption of the proposal in order to preserve the integrity of the profession and claimed the AICPA requires independence, in not only fact, but also appearance. Goodkind feels this guideline is the correct one to follow and should be preserved throughout all of the proposed changes for the sake of the investing public. Goodkind addressed the argument of MAS providing higher quality audits by inquiring if audits really need to be strengthened in such a manner and if so, couldn't they be strengthened in such a way that didn't raise any conflict? Goodkind claims the larger accounting firms are being greedy by offering these services. He specifically states "the primary motivation of an auditor should be to insure that the financial statements that the client prepared are materially correct, [and] should not be to offer extra services to their client no matter how lucrative" (Goodkind 2001).

The SEC didn't exclude foreign testimony from their all-inclusive questioning. Graham Ward spoke on behalf of the United Kingdom in order to voice one of the many global opinions of the impact these regulation changes would make. Ward agreed with the objective of strengthening auditor independence but felt certain principles needed to be emphasized. Ward quoted a leading UK journalist as stating, "Principles encourage compliance. Regulations encourage deception" (Ward 2001). Ward complimented the SEC on taking a conceptual framework approach to the issue, stating this design should be easily adaptable and coping. Ward did, however, remind the SEC of several potential problems with the proposal. Ward reiterated that there is no evidence of significant

breaches of auditor independence. Ward also claimed the argument that provision of MAS created economic dependency on the client was inherently flawed. Ward believes that the company being audited has the choice of auditor as well as the price they would like to pay. Ward suggested a limit be placed on the fees that could be realized outside of audit services in order to side-step this problem of appearance. Ward further claims that trying to prohibit some MAS and allowing others will not work very long because of the constantly changing business environment. Ward also claims prohibiting firms from accepting MAS from auditors is not in the best interest of the public, because the firms will have to settle for less knowledgeable advice. Ward concludes by claiming a revamp of the auditing model may cause the profession to lose some of its most qualified people and he urges the SEC to consider adopting similar policies to those adopted by other international accounting bodies.

Weil and Tannenbaum's (2001) Wall Street Journal article seems to sum up the profession's stance. Al Andersen, senior vice president at the AICPA, claims the debate is unnecessary because the AICPA has always "felt the investor could make informed decisions when there is disclosure [of non-audit services performed]" (Weil and Tannenbaum 2001). The "Big 5" maintain that independence is unaffected by the provision of MAS and several firms have already spun off or sold their consulting practices in the face of the SEC's campaign. George Ledwith, a spokesman for KPMG, claims "it's nonsensical to think that we'd jeopardize any audit relationship or put our independence at risk for the sake of other business" (Weil and Tannenbaum 2001). Spokespeople from GE and Motorola, both clients of KPMG, attest the reasons they use KPMG's non-audit services are based on knowledge and value. Larry Parnell of Ernst &

Young maintains the volume of non-audit services sold attests to the quality of work being provided by the large firms. Deborah Harrington of Deloitte & Touche argues that it is ridiculous to think large accounting firms don't take their independence seriously. She claims the accounting profession has too long a history and reputation to risk for the sake of a few dollars. Weil and Tannenbaum's article seemed to sum up the profession's maintained stance on the auditor independence issue.

The Academics Perspective on Auditor Independence

Academics have long searched for a theory providing evidence of a possible breach in auditor independence. Various methods have been used in attempts to explain the rational behind the different arguments for the auditor independence issue. Methods utilized include empirical research, experimental markets, and game theory principal-agent analyses. These studies and models provide important insight into the issues that may cause an auditor to breach their independence as well as attempt to validate some of the points of view regarding the auditor independence issue.

DeAngelo (1981) provides one of the most fundamental inquiries into the auditor independence debate. Although DeAngelo's model is simplistic, it provides a basis for which other researchers have been able to improve upon, including academics in search of auditor independence with the provision of MAS. DeAngelo's model describes 'lowballing', a practice that is commonly used to sell future audits. DeAngelo's model characterizes the intertemporal fee structure when incumbent auditors hold cost information advantages over competing auditors. With this information, incumbent auditors can earn client-specific quasi-rents. DeAngelo concludes that 'lowballing' does

not impair auditor independence in itself and is simply a competitive practice forced by the conditions of the audit marketplace.

Magee and Tseng (1990) explored the interactions of audit pricing and independence by constructing a multi-period model of the audit market for a single client with the introduction of a reporting issue over which the auditor and the client may disagree. The authors begin by presenting a simple model of pricing in order to examine the amount of price-cutting and the value of incumbency. The model then has a reporting disagreement between the client and the auditor added, which is followed by an examination of conditions that produce auditor independence. Finally, sufficient conditions for a compromise of independence are identified. Magee and Tseng's simple model produces results that are similar to those found in DeAngelo's (1981) 'lowballing' model but more useful when considering the problem of independence. Magee and Tseng's study differs from DeAngelo's work by using a dynamic programming approach.

Magee and Tseng also offer some interesting interpretations of their model. They propose that when all auditors agree that a reporting decision is consistent with proper application of GAAP, a positive incumbency value should not result in a compromise of independence. Furthermore, should auditors vary on consistency, it can be expected that auditors will not only begin competing on pricing, but on reporting as well. Finally, they conclude that established auditors with a wider client base could be expected to take a more conservative approach to the reporting dilemma.

Antle and Demski (1991) studied the relationship between contracting frictions, regulation and the structure of CPA firms. Specifically they looked at the contracting frictions arising from the private information about the costs of providing auditing and

consulting services for clients. The authors claim that such information may result in economies of scope, whereas the client will be better off purchasing auditing and consulting services from the same firm. To provide support for this claim, they construct a model including the costs for bundling services and later add the effects of regulation. This model is unique because it holds constant the impact of auditor independence in order to study the economic efficiencies provided from allowing auditors to provide MAS. This study focuses on the implications on economies of scale and provides a valid argument for the allowance of MAS for audit clients. Antle and Demski conclude that economies of scope do exist based on an informational advantage held by the incumbent auditor. Antle and Demski also conclude that there is no benefit for having regulations for MAS in place. Regulations would generate a restriction of MAS and may force a change on the quantity of MAS purchased.

Kanodia and Mukherji (1994) explore the issue of auditor turnover using a dynamic analysis. They utilize a static model of 'lowballing' that illustrates basic economic forces on equilibrium audit prices and make several assumptions contrary to DeAngelo's work. Their model assumes the client has bargaining power rather than the auditor, allows the client to sign one period contracts with auditors, and in the process of conducting the audit the auditor acquires private information on the recurring cost of auditing a client. The first assumption gives the client the ability to specify the price mechanism, while the second disallows the client from making long-standing contracts with auditors. The third assumption states that initially the client and all potential auditors have a range of costs for the audit. The authors claim that future information asymmetry is the main force underlying their analysis. Kanodia and Mukherji's study

differs from prior research by determining that client pressure is a less serious problem than illustrated in DeAngelo's (1981) work. They support this claim by incorporating two factors in their model. These factors require that the client not know the recurring cost of providing the audit and that the auditor's value of retaining a client is lower when the client holds the bargaining power.

Simunic (1984) conducted a survey to analyze the decision to purchase MAS and audit services from the same provider. Simunic contrasted the arguments made by the Metcalf Committee and the Cohen Commission. Simunic characterized the Metcalf Committee's stance on MAS as a conflict of interest while the Cohen Commission's study failed to find any evidence of substandard audits. Simunic claims these two views imply the MAS debate can be reduced to a cost/benefit tradeoff where certain MAS possibly hinder auditor independence while overall the combination increases the audit quality. Simunic disputes that there is more to the problem than the cost/benefit tradeoff. Simunic claims the joint performance of services leads to the auditor receiving economic rents that cannot be transferred to equally profitable alternative uses as well as increasing the probability the auditor will report truthfully based on the argument that if the auditor is dismissed from auditing services, it stands a greater chance of losing any future MAS as well. The importance of the first point is not as clear as the second, but Simunic argues by giving an example of one firm that is earning economic rents with one that is not. The marginal benefits and costs of losing the client are indifferent to the firm not receiving economic rents, while Simunic points out the firm receiving rents will not want to be dismissed.

To test this stance, Simunic formed hypotheses that were further tested using fee data collected from publicly held companies in the U.S. The results were “(1) companies which purchased MAS from their auditors are similar (with respect to the [audit fees and other control variables]) to companies which did not purchase MAS from their auditors, (2) the purchase of MAS from the auditor is associated with a significant increase in the audit fee, and (3) the purchase of MAS from the auditor is not significantly associated with the cost of audit substitutes [such as better internal auditing] employed by the company” (p. 697-98). Simunic concludes that the management of firms used in his study were not better nor worse off financially or service provided wise for having purchased the MAS compared to other firms and also purchased MAS from their auditors because it maximized the value of the firm.

Palmrose (1986) attempted to replicate Simunic’s study. Her study investigated the effect of MAS on the pricing of audit services. She found evidence of a strong positive relation between fees for audit services and fees for MAS and more specifically, that this relationship remained true whether or not the incumbent auditor was the supplier of the MAS. She claimed the widespread use of incumbent auditors for MAS proved that clients perceived there was an advantage of to allowing the MAS to be provided by the incumbent auditor.

Beck, Frecka, and Solomon (1988) extended Simunic (1984) and Palmrose (1986) by investigating the effects of MAS involvement on the tenure of auditors. Their study extended previous research by empirically testing the relationship between the auditor tenure and provider of MAS. The authors compared the tenure distribution of a sample of audit clients that had also purchased a high level of MAS with a control sample that

had not. The authors compared data compiled between 1969 and 1985. Over 82 percent of available subjects retained their same auditor during the eleven-year period 1969-79. Beck, Frecka, and Solomon hypothesize that the stronger the economic bond between client and auditor, the less auditor change can be found. The authors claim although statistically significant results were found, the average tenure on the auditee subpopulation implied that bonding effects formed by MAS are small when compared to other sources of bonding such as bonding associated with the audit. They concluded that auditor independence is not impaired substantially by the purchase of MAS services and reinforced the findings of previous work in this area.

In a study sponsored by the Peat Marwick Foundation, Pany and Reckers (1988) questioned the previous research in the MAS area. Pany and Reckers characterize the profession's stance as being one of solely a perception problem rather than a lack of independence, since there is a lack of evidence provided by the government or academics. While the SEC seemed to agree with the profession, the members claim independence perceptions are critical in maintaining investor confidence and the integrity of financial reporting. It is this difference of opinion that has provided over twenty years of surveys and studies that seem to conclude the same basic premise of the independence perception problem.

Pany and Reckers attempted to prove that the studies previously conducted had utilized methods that drove results. In general, increased performance of MAS had lead to a decreasing perception of independence in the past studies, which Pany and Reckers felt was due to the set up of the experiments. The authors conducted an experiment requiring loan officer subjects and financial analyst subjects to evaluate

information related to a potential common stock investment. Pany and Reckers administered several cases to these subjects that had manipulated the amount of MAS provided and required the subjects to assess their opinion on three questions. The questions asked how confident the user of the statements were that the statements were free of material fraud, how confident the user was that the statements had been prepared in accordance with generally accepted accounting principles, and their confidence level on whether the statements were free of material clerical errors. Their study contradicted past studies by concluding the provision of MAS leads to little or no effect on typical investment or credit granting decisions and perceptions.

Scheiner (1984) questioned the impact of the SEC's requirement for firms to disclose non-audit services. The article focused on ASR No. 250 disclosure requirements, set up in 1978 and subsequently rescinded, in order to determine whether the requirement was repealed because it was found to be ineffective. This research provides valuable information even today in order to understand disclosure requirement rules. This is especially important due to the SEC recently requiring disclosure rules for MAS services. Scheiner's empirical assessment accumulated two years of data on non-audit services in order to measure the amount of disclosure information and types on non-audit services provided. Scheiner's study indicated the original rules set forth in ASR No. 250 did not appear to have a substantial impact on the amount of non-audit services provided by independent auditors, based on an unvaried provision of non-audit services by accounting firms.

Dopuch and King (1991) used an experimental markets study towards understanding the impact of MAS on auditor independence. The authors claim this

approach to the issue provides a directly observable approach, whereas past attempts to describe this issue have been indirect. The experimental settings were not created based on a formal model, but do encompass the essentials of a market, such as designing the market around fundamental transactions of sellers offering a dividend-paying asset. Twelve markets were set up with six markets having restrictions placed on auditors offering MAS and the other six with no restrictions. Auditors who chose not to acquire information on the client faced a reputation cost. A component was also built in for a negligence liability rule. In the experiment auditors also providing MAS shirked more in terms of collecting costly information, probably due to an increase in information provided by the MAS. The study concluded that auditors that provided MAS were more likely to shirk because their firm had provided the services, rather than verifying another firm's work. The study also provided evidence of no systematic patterns developing regarding clients rehiring their auditor.

A second result of the Dopuch and King paper was a comparison of markets that restricted MAS from being provided with those markets that did not. Dopuch and King reasoned that markets with no restrictions were able to produce a single product consisting of auditing and MAS with one price. Markets that were held by restrictions found that some firms specialized in auditing while others specialized in MAS. Dopuch and King believe that should these restrictions be placed in the profession we should presume to see a similar separation and specialization among the auditing firms.

Summary and Conclusions

The auditor independence debate has raged for over twenty-five years with very little change since the original question was posed. The government has tapped numerous resources, throughout the history of the debate from the Metcalf Committee to the recent SEC inquiries, in an effort to find a solution agreeable to all parties. The profession has maintained auditor independence is the cornerstone of their business and that none would sacrifice this sacred principle. Academic research continues to search for theories where an auditor would violate independence, as well as provide theoretical evidence to support the various arguments for and against the provision of MAS. Academic models provide intriguing arguments for what conditions would lead to these violations. This debate seems to still be far from a final solution satisfactory for all parties.

This study has provided an in-depth look at the auditor independence issue. A survey has been taken from governmental, professional, and academic literature in order to assess the current position of the debate and where future academic research should be devoted to in order to reach a solution among the consensus. The following suggestions have been provided in hopes that future research will answer these questions and lead to the economically efficient solution for this debate.

One of the most important questions posed by this debate seems to be the value of independence in appearance. For the most part, the three communities believe that independence in fact is preserved and will continue to be preserved in the future. Some argue that independence in appearance remains vital to the profession in order to maintain investor confidence, as opposed to independence in fact which is necessary for

the audit market to exist. If this argument is true, then the question of will independence in appearance, once a hallmark of the profession, continue to serve a purpose in the future? Other economies, such as Great Britain, have abandoned this requirement in an effort to increase the efficiency of their economy. The U.S. Government should strongly consider abandoning its pursuit of both independence in appearance and fact in favor of independence in fact to allow for a more efficient economy.

The difficulty of requiring independence in fact without independence in appearance lies in the transparency of independence in fact. While it is true that requiring independence in appearance may make it easier for observing independence in fact, it may also be damaging to the efficiency of the economy. The U.S. Government should not insist on the policy that is easier for them to regulate, but should instead focus on the policy that is most beneficial to society.

Disallowing certain non-audit practices while allowing others would not only create confusion in the market for MAS, it would provide only a temporary solution to the ever-changing needs of the business community. The U.S. Government would be best served by not even considering this option as a way to regulate MAS. If such a plan of action was put in place, the laws should be written with a vagueness so as to allow room for interpretation. Even this course of action would monopolize much of the courts' time as they attempt to form case law, whereas a simple allowance of these MAS practices would promote economic efficiency by saving not only time but money as well.

The profession may want to consider exactly where they stand on the issue of maintaining providing these services. They seem to be sending a mixed message when some of the larger firms spin off or sell their consulting work. This mixed message

further complicates the auditor independence debate by adding a favorable argument to the U.S. Government's side. Standardization should be reached across the industry in order to maintain a unified stance in the face of the investing public and the U.S. Government.

Academics could help with this by attempting to discover the value of independence in appearance. They could utilize surveys to see what the investing public thinks about this issue. They could also apply models to determine theories of the value of independence in appearance to creditors and banks as well as search for any reasons why independence in appearance and fact would be preferred over independence in fact. These matters may help the profession advance and make a bigger contribution to society.

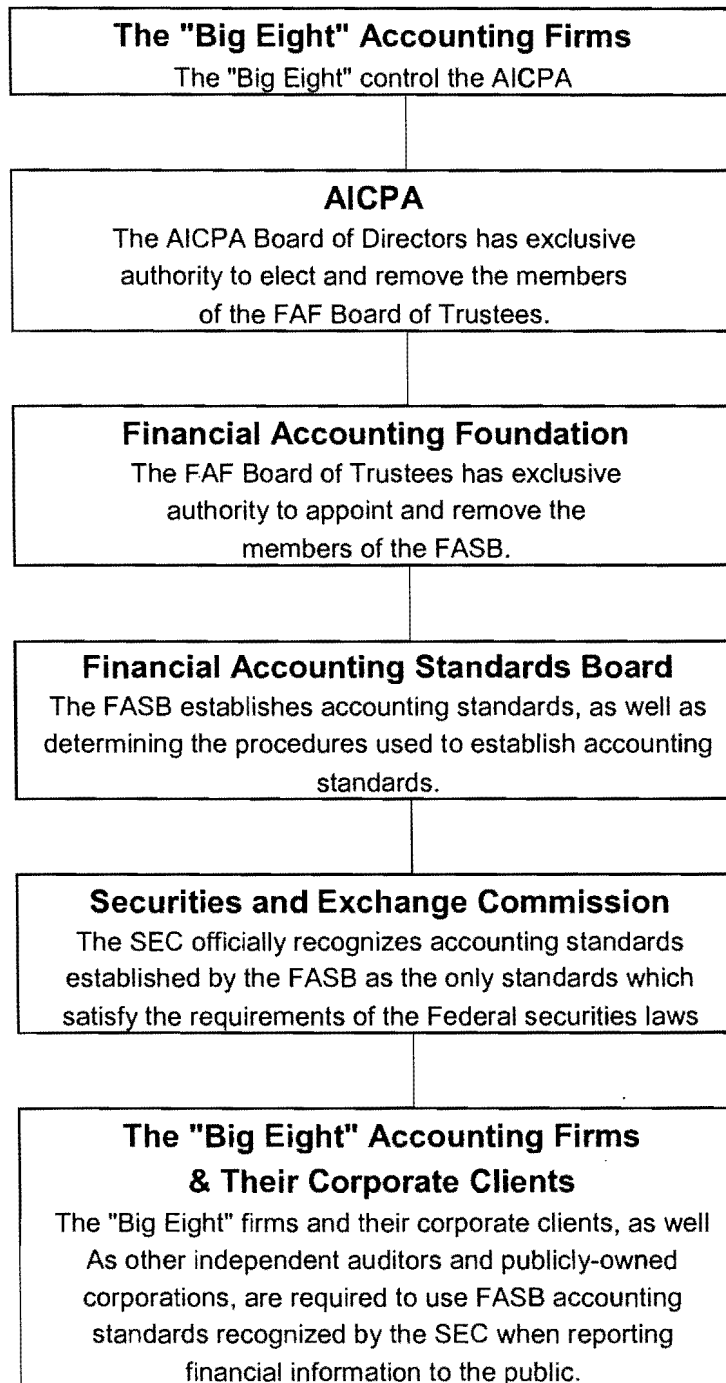
With the increasing consciousness of globalization, the U.S. Government should consider the impact any changes in auditor independence would have. With the formation of international accounting regulating bodies the U.S. Government may want to consider taking a step towards a unified system and may allow MAS to be performed as they are in other countries. Restricting MAS would move the U.S. further away from meeting this possible goal. Academics should interject by studying and assessing whether a global accounting system could be feasible and at what point in time this could happen.

Academics should continue to search for potential breaches in auditor independence in order to aid the U.S. Government in looking for failures. Evidence based on theoretical models would help the U.S. Government design regulations in order to monitor auditor independence. Although an easing of the debate over auditor

independence may allow other important questions to take precedence, an actual audit failures may devastate not only the profession, but would radically reverse any leniency the U.S. Government would allow. Models and studies will help prepare a monitoring system in order to preserve the integrity the profession has strived so hard to preserve as well as maintain confidence in the markets.

Table 1

Metcalf Committee's Illustration of How the "Big Eight" Accounting Firms Maintain Control Over Accounting Standards



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